

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

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Southern Union Company)	D.T.E. 03-3
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POST-HEARING COMMENTS OF SOUTHERN UNION COMPANY

I. INTRODUCTION

On January 13, 2003, Southern Union Company (“Southern Union” or the “Company”) filed a petition with the Department of Telecommunications and Energy (the “Department”) for approval and authorization: (1) to invest up to \$662.3 million in Southern Union Panhandle Corp. (“Southern Union Panhandle”), pursuant to G.L. c. 164, § 17A; and (2) to issue common and/or preferred stock up to an aggregate value of \$300, pursuant to G.L. c. 164, §§ 14 and 16. The Company is requesting authorization to issue up to \$300 million in common and/or preferred equity for the purpose of adjusting the Company’s capital structure following the investment, to retire long-term debt, and to fund utility operations.

As discussed herein, the record in this proceeding shows that, upon consideration of all of the significant aspects of the proposal, the Company has met the Department’s public interest standard under G.L. c. 164, § 17A because the transaction will produce significant value for both customers and shareholders in terms of improving the overall financial position of the Company and creating the opportunity for the realization of financial and operational efficiencies. Similarly, the Company has demonstrated that it has met the Department’s two-part standard under G.L. c. 164, §§ 14 and 16 for the approval and authorization to issue stock because the record shows that: (1) the proceeds from the stock issuance will be used to repay long-term debt, redeem existing

preferred securities and strengthen the balance sheet, which is a legitimate utility purpose under Department precedent; and (2) the Company's net-plant utility plant following the stock issuance will exceed the Company's total capitalization, as calculated consistent with Department precedent. Accordingly, the Department should approve the Company's requests for authorization and approval to invest \$662.3 million in Southern Union Panhandle and to issue common and/or preferred stock up to an aggregate value of \$300 million.

II. PROCEDURAL HISTORY

The Company submitted its initial filing on January 13, 2003. On January 28, 2003, the Department conducted a public and evidentiary hearing at its offices. At the evidentiary hearing, the Company presented one witness: David J. Kvapil, Southern Union's Executive Vice President and Chief Financial Officer, who testified in support of the Company's request for authorization to invest funds and to issue stock. In addition to the sworn testimony presented at the hearing, the evidentiary record consists of approximately 30 documentary exhibits, including the initial filing and the Company's responses to information and record requests issued by the Department. There are no intervenors in this proceeding. This brief is filed in accordance with the schedule established by the Hearing Officer.

III. DESCRIPTION OF THE PROPOSALS

A. Introduction

There are two components of the Company's petition in this proceeding. First, Southern Union seeks approval and authorization, pursuant to G.L. c. 164, § 17A, to invest up to \$662.3 million in Southern Union Panhandle, a Delaware corporation that will acquire the Panhandle Eastern Pipe Line Company ("Panhandle Eastern"), which is currently owned by the CMS Gas

Transmission Company (“CMS”).¹ Second, the Company seeks approval and authorization, pursuant to G.L. c. 164, §§ 14 and 16, to issue shares of common and/or preferred stock with an aggregate value of up to \$300 million for the purpose of adjusting the Company’s capital structure to improve the capitalization ratios, to retire long-term debt, and to fund utility operations (Exh. SU-1, at 15; Exh. SU-11; Exh. SU-26; Tr. at 32). Although the proceeds generated from the equity issuance are not needed to fund the Company’s proposed investment in Southern Union Panhandle, the stock issuance is an integral part of the Company’s transaction to acquire the Panhandle Eastern assets (Tr. at 38-39, 43-47). The Company has provided substantial information on the record documenting the favorable reviews by the investment community in relation to Southern Union’s plan to acquire the Panhandle assets, which includes the post-transaction steps to recapitalize the balance sheet (Exh. SU-13; Exh. SU-16 (supp.); Tr. at 16, 60). The Department’s approval of these two proposals will allow the Company to move forward to take advantage of a unique opportunity to produce value for customers and shareholders and to fulfill the potential acknowledged by the investment community.

B. Description of the Acquisition

Under the terms of a Letter Agreement and Stock Purchase Agreement, Southern Union will enter into an arrangement with AIG Highstar Capital, L.P. (“AIG Highstar”) and AIG Highstar II Funding Corp. (“AIG Funding”), a private equity fund sponsored by American International

¹ Panhandle Eastern is a “natural gas company” as defined in Section 2 of the Natural Gas Act (15 U.S.C. § 717) and is subject to all rules and regulations promulgated by the Federal Energy Regulatory Commission. Panhandle Eastern is engaged in the interstate transportation and storage of natural gas and the storage and re-gasification of liquefied natural gas (“LNG”) (Exh. SU-1, at 6). Panhandle Eastern operates a network of almost 11,000 miles of mainline natural gas pipeline facilities extending from the Gulf of Mexico to the Midwest United States and Canada (*id.*). The Panhandle Eastern pipelines have a combined peak-day delivery capacity of 5.4 billion cubic feet, 88 billion cubic feet of underground storage capacity and 6.3 billion cubic feet of above-ground LNG storage facilities (*id.*).

Group, Inc., to acquire an equity interest in Southern Union Panhandle, which will purchase the interstate-pipeline distribution operations of Panhandle Eastern (Exh. SU-2). To complete the transaction, Southern Union Panhandle will acquire from CMS all of the issued and outstanding shares of Panhandle Eastern (Exh. SU-1, at 4; Exh. SU-2). The total consideration to be paid by Southern Union Panhandle for these shares is approximately \$662.3 million in cash (plus or minus any change in net working capital and total debt from that as of September 30, 2002), and the assumption of debt in the amount of approximately \$1.17 billion (Exh. SU-1, at 2-4; Exh. SU-7).

To fund this transaction, Southern Union will invest up to \$512 million in Southern Union Panhandle, which will be jointly owned by Southern Union (approximately 77.9 percent) and AIG Highstar (approximately 22.1 percent) (Exh. SU-1, at 5-6).² AIG Highstar will invest up to \$150 million to accomplish the transaction (*id.*). Southern Union will fund its portion of the investment in Southern Union Panhandle primarily with the cash proceeds generated from the sale of its Texas operations (approximately \$420 million) (*id.*). The remainder of its share of the investment, up to approximately \$100 million will be funded by Southern Union using available resources, including short-term debt (Exh. SU-1, at 11).

With respect to the Panhandle Eastern debt that will be assumed by Southern Union Panhandle under the arrangement (approximately \$1.17 billion), the record shows that the holders of this debt will have no legal rights against Southern Union Panhandle, or more importantly, to

² Although Southern Union anticipates investing approximately \$512 million to consummate the transaction, the Company is requesting authorization to invest up to \$662.3 million for two primary reasons: (1) to structure the transaction so as to enable a “like-kind” exchange of assets (Exh. SU-1, at 9; Tr. at 38-40); and (2) to ensure CMS that the joint venture partners could complete the transaction in the unlikely event that AIG Highstar was to decide to lessen its participation in the transaction prior to closing (Exh. SU-1, at 13). The record shows that the Company anticipates that AIG Highstar will participate at the projected level of \$150 million (Tr. at 38).

Southern Union Company (Exh. SU-1, at 4; Exh. SU-14; RR-DTE-2; Tr. at 14-15). This means that Southern Union's assets, including its local gas distribution assets, or any assets held by Southern Union Panhandle, may not be attached by the Panhandle Eastern debt holders to satisfy the debt obligations in the event that there is a default on the Panhandle Eastern debt instruments (Exh. SU-7; Tr. at 14; RR DTE-2). Given this structure, none of Southern Union's utility assets and operations would be used to provide security to the Panhandle Eastern lenders (id.).

For federal income-tax purposes, the transaction will be structured as a "like-kind exchange" with the shares first transferred to a qualified intermediary and then from the intermediary to Southern Union Panhandle (Exh. SU-15; Tr. at 37-38). Post closing, AIG Highstar and AIG Funding will have the right to acquire a non-voting equity interest in Southern Union Panhandle (Exh. SU-1, at 5). Although it is the intent of the parties to accomplish the transaction with a \$150 million investment by AIG Highstar, to qualify as a like-kind exchange under the Internal Revenue Service ("IRS") rules, the Company must be the initial purchaser of 100 percent of the equity interest associated with Panhandle (Exh. SU-1, at 12; Tr. at 38-40). Accordingly, pursuant to the Stock Purchase Agreement, Southern Union has "guaranteed" the performance of AIG Funding, which together with Southern Union is responsible for providing up to 96.3 percent of the purchase price (Exh. SU-1, at 12; Exh. SU-2). This guarantee is a necessary component of the overall transaction because it enables and maintains the like-kind exchange under the IRS rules (id.). Also, Southern Union's guarantee of the performance by AIG Funding is consistent with general practice in joint venture transactions where one partner typically ensures the seller that funding will be available to complete the sale (id.). Here, Southern Union is providing a guarantee of the financial

performance of AIG Funding primarily to enable the like-kind exchange, but also to assure the seller that the transaction will be completed (id.).

Despite the joint venture, neither AIG Highstar nor AIG Funding will have any voting shares of Southern Union Panhandle, any rights to name members of the Board of Directors of Southern Union Panhandle, or any rights to have an observer at board meetings of Southern Union Panhandle (Exh. SU-1, at 7). Moreover, AIG Highstar and AIG Funding will have no rights to participate in ordinary course management decisions of Southern Union Panhandle (id.). Instead, the day-to-day management and operation of Southern Union Panhandle will be conducted by employees of the Panhandle Eastern companies under the direction and control of Southern Union (Exh. SU-1 at 7). In addition, Southern Union will provide various corporate services to Southern Union Panhandle, including treasury, risk management, and employee-benefit administration (id.; Tr. at 20-21).

C. Description of the Stock Issuance

In this filing, the Company is also requesting authorization to issue common and/or preferred stock with an aggregate market value of up to \$300 million. This need for this issuance stems, at least in part, from discussions with financial analysts regarding the arrangement with AIG Highstar and the acquisition of Eastern Panhandle, which led the Company to recognize that there was a need to achieve more favorable capitalization ratios following the transaction through the issuance of additional equity and the repayment of long-term debt, in order for the transaction to be well-received by the investment community (Exh. SU-1, at 15; Exh. SU-8; Exh. SU-20; Exh. SU-25). As a result, the Company is planning to use the proceeds from the stock issuance primarily for repayment of indebtedness and the redemption of existing preferred securities in order to maintain

and enhance the Company's capitalization ratios and overall financial position on a going forward basis (id.).

The record in this proceeding indicates that the Company will achieve the recapitalization in the most cost-effective manner possible with the end result being a capital structure that strikes an appropriate balance between debt, common equity and preferred securities. The record also shows that the Company is currently working with its investment bankers to determine how to best structure the issuance to achieve this goal while taking maximum advantage of market conditions (Tr. at 49-51; Exh. SU-8). The record further shows that final determinations on the type of equity instrument used (i.e., common or preferred stock), and the number and price of shares to be issued, will not be made until days or even hours prior to the issuance (Tr. at 50-51). Therefore, the Company needs to maintain a level of flexibility in issuing the equity securities in order to tailor the issuances to meet market conditions (Tr. at 49-51). Notwithstanding the need for flexibility, however, the record shows that, of the \$300 million total issuance, approximately 50 percent is likely to be issued as common stock and approximately 50 percent is likely to be issued as preferred securities (Exh. SU-10 (confidential); Tr. at 12-13). The Company also stated that it anticipates that the issuances will be completed within six months of the closing of the transaction (id.).

With respect to the preferred securities, the record shows that the Company will issue one or more of three forms of preferred stock: (1) trust originated preferred securities/redeemable preferred stock; (2) "straight" preferred stock; or (3) mandatory convertible preferred stock (Exh.

SU-18; Tr. at 9-12).³ By issuing a combination of types of preferred stock (in addition to common stock), the Company can take advantage of current market conditions and meet its projected capitalization goals over the next several years (Tr. at 10). For example, the record indicates that ratings agencies consider mandatory convertible stock to be more equity-like than other forms of preferred stock because it automatically converts to common stock and may not be cancelled or recalled by the Company at a point in the future (Tr. at 10). Therefore, the Company could issue mandatory convertible preferred stock to meet the longer-term goal of increasing common-equity levels, without creating the downward pressure on the Company's stock price in the short term, which can occur in relation to a common stock issuance (Tr. at 10). Alternatively, the Company could issue perpetual straight preferred stock in order to add a permanent layer of equity capital to its balance sheet (Tr. at 10; Exh. SU-16; Exh. SU-18). The Company also could issue trust originated preferred securities, which are generally classified as equity for Generally Accepted Accounting Purposes, but which allow for the tax deductibility of interest payments paid to the issuing trust (Tr. at 10).

The record further shows that the Company anticipates that mandatory convertible preferred stock would be issued at a rate of 6.5 to 7.5 percent and that the trust-originated preferred securities would be issued at a rate of 8.0 to 9.0 percent (Exh. SU-18).

³ "Straight" preferred stocks have a fixed quarterly dividend and are considered to be equity for balance sheet purposes (*id.*). Mandatory convertible preferred stocks have a quarterly dividend rate (usually fixed) and automatically convert into common equity at a certain point or upon the occurrence of a designated event (*See* Tr. at 10). Trust originated preferred securities ("TOPRS") are a hybrid between debt and straight preferred stock (equity). With TOPRS, a company issues subordinated debt to a special purpose trust, which in turn issues the preferred securities. The subordinated debt has the same interest rate as the dividend rate that is paid to the holders of the TOPRS, however, under IRS regulations, the company is permitted to deduct the interest costs on the subordinated debt for income tax purposes (*id.*).

In order to market the common and preferred securities, the Company will rely on one or more investment bankers who will assist the Company in determining the type and timing of the issuance depending on a number of factors (Tr. 49-50). In terms of the process of a stock issuance, the Company and its financial advisors will first make presentations to potential investors or stockbrokers to assess the interest in Southern Union's stock (Tr. at 55-57). The actual issuance will be shaped, at least in part, by the feedback received from the participants at those presentations, as well as an assessment of general economic and political conditions, which are continually evaluated by the Company (Tr. at 51).

D. Capital Structure of the Company

As of September 30, 2002, the Company's consolidated balance sheet reflects plant in service totaling \$2,278,998,000 (excluding Construction Work in Progress of \$22,118,000), less accumulated depreciation of \$838,741,000 (Exh. SU-1, at 18-19; Exh. SU-5). Therefore, including gas inventories of \$139,193,000, the total net plant in service as of September 30, 2002, is \$1,601,568 (id.). The Company's long-term debt and capital lease obligations as of September 30, 2002 totaled approximately \$1,247,395,000 (including preferred stock issued by a subsidiary trust of the Company), resulting in a total capitalization of \$1,927,312,000 (id.). As discussed below, Southern Union's net-utility plant calculation as of September 30, 2002 (under Department precedent) will be in excess of total capitalization by \$381,667,000 following the proposed issuance of preferred and/or common stock in an aggregate value not to exceed \$300 million (id.).

IV. STANDARD OF REVIEW

A. G.L. c. 164, § 17A

Section 17A provides, in relevant part:

No gas or electric company shall, except in accordance with such rules and regulations as the [D]epartment shall from time to time prescribe, loan its funds to, guarantee or endorse the indebtedness of, or invest its funds in the stocks, bonds, certificates of participation or other securities of any corporation, association or trust unless said loan guaranty or endorsement, or investment is approved in writing by the [D]epartment.

G.L. c. 164, § 17A.

In Bay State Gas Company, D.P.U. 19886 (1979), the Department noted that no explicit standard of review is provided by § 17A, or in judicial or administrative construction of the statute. The Department, however, has recognized that the primary purpose of § 17A is to protect the ratepayers by assuring a utility's stable financial condition.⁴ In D.P.U. 19886, the Department also noted that “in keeping with the Supreme Judicial Court’s interpretation of G.L. c. 164, § 14, we believe that implicit in the statutory framework in which § 17A is found is that a proposed investment must be consistent with the public interest.”

In Boston Edison Company, D.P.U. 850 (1983), the Department further defined the parameters of a § 17A proposal, which is “consistent with the public interest:”

The General Court did not, in our view, intend that proposals be held “inconsistent” with the public interest merely because a fair assessment of the relevant factors recognizes that both beneficial and negative aspects may attend those proposals. Consequently, even if a particular proposal has negative aspects, we will find that such a proposal is consistent with the public interest if, upon consideration of all its significant aspects viewed as a whole, the public interest is at least as well served by approval of the proposal as by its denial.

⁴ Commonwealth of Mass., Dept. of Pub. Util., Recommendations of the Department of Public Utilities to the General Court at 2, House Doc. No. 53 (1954); see also E. Gadsby, 1 Annual Survey of Massachusetts Law at 182 (1954).

In Bay State Gas Company, D.P.U. 91-165 (1992), the Department reaffirmed the standard of review articulated in D.P.U. 850, that proposals filed under § 17A must be consistent with the public interest, and that they meet this standard if, upon consideration of all of the significant aspects of a proposal, the public is at least as well served by approval of the proposal as by its denial. In D.P.U. 91-165, at 7, the Department further noted that the application of the consistency standard in a § 17A case is based on the totality of what can be achieved by the proposal rather than a determination of any single gain which might be derived from the proposed transactions.

The Department also found that the consistency standard best accommodates the Department's interest in protecting the utility's ratepayers from the adverse effects of unwarranted § 17A transactions and a utility's interest in having flexibility in a changing marketplace to meet long-term objectives of its ratepayers and shareholders. D.P.U. 91-165, at 7. In D.P.U. 91-165, the Department articulated some of the factors that should be considered in evaluating § 17A petitions. These include:

the nature and complexity of the proposal, the relationship of the parties involved in the underlying transaction, the use of the funds associated with the proposal, the risks and uncertainties associated with the proposal, the extent of the regulatory oversight on the parties involved in the underlying transaction, and the existence of safeguards to ensure the financial stability of the utility. After consideration of such a petition, viewed as a whole in light of the described factors, the Department may approve a § 17A investment if it finds the investment is consistent with the public interest.

After consideration of such a petition, viewed as a whole in light of the described factors, the Department may approve a § 17A investment if it finds the investment is consistent with the public interest.

B. G.L. c. 164, §§ 14 and 16

In order for the Department to approve the issuance of stock, bonds, coupon notes or other types of long-term indebtedness⁵ by an electric or gas company, the Department must determine that the proposed issuance satisfies two requirements. First, the Department must assess whether the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations, pursuant to G.L. c. 164, § 14. Boston Edison Company, D.T.E. 00-62, at 2; Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 395 Mass. 836, 842 (1985) ("Fitchburg II"), citing Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 394 Mass. 671, 678 (1985) ("Fitchburg I"). Second, the Department must determine whether the Company has met the net plant test pursuant to G.L. c. 164, § 16.⁶ Colonial Gas Company, D.P.U. 84-96 (1984).

The Supreme Judicial Court has found that, for the purposes of G.L. c. 164, § 14, "reasonably necessary" means "reasonably necessary for the accomplishment of some purpose having to do with the obligations of the company to the public and its ability to carry out those obligations with the greatest possible efficiency." Fitchburg II at 836, citing Lowell Gas Light

⁵ "Long-term" refers to periods of more than one year after the date of issuance. See, e.g., Boston Edison Company, D.T.E. 00-62, at 2, fn.2 (2000).

⁶ The net plant test is derived from G.L. c. 164, § 16. When the Department approves an issue of new stock, bonds or other securities by a gas or electric company, if it determines that the fair structural value of the plant and of the land and the fair value of the nuclear fuel, gas inventories or fossil fuel inventories owned by such company is less than its outstanding stock and debt, it may prescribe such conditions and requirements as it deems best adapted to make good within a reasonable time the impairment of the capital. See G.L. c. 164, § 16.

Company v. Department of Public Utilities, 319 Mass. 46, 52 (1946). In cases where no issue exists about the reasonableness of management decisions regarding the requested financing, the Department limits its § 14 review to the facial reasonableness of the purpose to which the proceeds of the proposed issuance will be put. Canal Electric Company, et al., D.P.U. 84-152, at 20 (1984); see, e.g., Colonial Gas Company, D.P.U. 90-50, at 6 (1990).

Regarding the net plant test, a company is required to present evidence that its net utility plant (original cost of capitalizable plant, less accumulated depreciation) equals or exceeds its total capitalization (the sum of its long-term debt and its preferred and common stock outstanding) and will continue to do so following the proposed issuance. Colonial Gas Company, D.P.U. 84-96, at 5.

V. THE COMPANY'S PROPOSAL MEETS AND EXCEEDS THE DEPARTMENT'S STANDARD OF REVIEW UNDER G.L. c. 164, §§ 14, 16 AND 17A.

A. The Company Has Demonstrated that the Investment of Funds is in the Public Interest.

As noted above, the Department has determined that, under G.L. c. 164, § 17A, a petitioner must demonstrate that its proposal is consistent with the public interest and that a petitioner would meet this standard if, upon consideration of all of the significant aspects of a proposal, the public is at least as well served by approval of the proposal as by its denial. See Bay State Gas Company, D.P.U. 91-165 (1992). The Department has further noted that the application of the public-interest standard in a § 17A case is based on the totality of what can be achieved by the proposal rather than a determination of any single gain (or loss) that might be derived from the proposed transactions. Id. In this proceeding, the record shows that the

proposed transaction, including the Company's proposal to recapitalize its balance sheet through the issuance of common and/or preferred equities and other initiatives, is in the public interest because in the long run, the arrangement will improve the financial position of the Company, and therefore, customers will be at least as well served by approval of the Company's petition as they would be by its denial. Therefore, the Department should approve the Company's request for approval under G.L. c. 164, § 17A.

With regard to the specific benefits of the arrangement, the Company has established that acquisition of the Southern Union Panhandle operations, which are comprehensively regulated by the Federal Energy Regulatory Commission ("FERC"), will substantially strengthen the financial position of the Company (Exh. SU-1, at 3, 8-11; Exh. SU-10 (confidential)). As the record shows, the Panhandle Eastern assets generate a stable, regulated rate of return of approximately 13 percent, which is generally more than is allowed for local gas distribution facilities (Tr. at 59). The record also shows that the addition of the Panhandle Eastern operations, in the first full year of operation following the acquisition (2004), will: (1) increase operating revenues by over 20 percent; (2) increase net earnings before interest, taxes, depreciation and amortization ("EBITDA") by over 70 percent as compared to FY 2002; and (3) will increase the per-share book value of the Company by approximately 10 percent (Exh. SU-1, at 8).

The record demonstrates that, given these attributes, the investment community has reacted positively to the Company's overall proposal (Exh. SU-16; Tr. at 16-17). For example, Moody's Investor Service ("Moody's") has announced a financial outlook for Southern Union of "stable," based on the assumptions that: (1) necessary regulatory approvals would be obtained in a timely manner; (2) Southern Union would move forward with a "sizeable equity offering;" and (3)

Southern Union will continue its plan to de-leverage its balance sheet through other measures, including the monetization of non-essential Panhandle assets (Exh. SU-16 (Supp.) at 2).

The record also shows that there are other reasons that financial market analysts are supportive of the Company's proposal, aside from the earnings potential associated with the proposed transaction. For example, the record shows that the Company is proposing to purchase an asset at a price that is significantly lower than the price paid by the current owner (CMS) in 1999,⁷ and that is likely priced below its long-term value because of an influx of high-quality pipeline assets to the market, which is exerting a downward pressure on prices (Exh. SU-6; Exh. SU-13). This is because several companies such as CMS are seeking to divest core assets in order to address liquidity issues (Exh. SU-13). The reduced purchase prices make these assets attractive to investors such as Southern Union that are financially sound and have access to capital resources in order to accomplish the purchase (id.). Based on these circumstances, the investment community recognizes that Southern Union's purchase will create a long-term potential for increased earnings, enhanced cash flow and financial stability (Tr. at 59). Moreover, because Panhandle Eastern is an entity regulated by FERC, the earnings are stable and predictable, which is an additional factor that is attractive to the investment community.

A second benefit of the proposed investment is that the transaction is structured to allow Southern Union to substitute the Texas local gas distribution operations with the Panhandle Eastern interstate pipeline operations through a "like-kind exchange" of property pursuant to Section 1031 of the IRS Code of 1986, as amended (Exh. SU-1, at 9; Tr. at 38-39). By structuring the

⁷ The record shows that Southern Union Panhandle will acquire the Panhandle Eastern assets for approximately \$1.8 billion in cash and the assumption of debt, as compared to the \$2.2 billion that CMS paid for the same assets in 1999.

transaction as a like-kind exchange, Southern Union will be eligible to defer approximately \$100 million of federal tax liability that would otherwise be payable upon the sale of the Texas operations (id.). This represents a significant savings for the Company (Exh. SU-1, at 9).

Third, as a result of the acquisition, Southern Union's Massachusetts customers will realize benefits stemming from the Company's enhanced financial position (Exh. SU-1, at 8; Tr. at 19-20, 65-66). Southern Union is acquiring an interest in a business entity that is roughly four times the size of the recently divested Texas facilities in terms of asset value (Exh. SU-1, at 8). Given this vastly increased size, Southern Union will be the beneficiary of substantially improved buying power, which will enable the Company to purchase plant, materials and other commodities at discounted prices for the benefit of all of its component operations (Tr. at 20). The record shows that, it is the Company's expectation that those discounts would accrue directly to customers of its distribution operations, including those taking service from the Company in Massachusetts (id.).

Similarly, as a result of the acquisition, there is the opportunity to achieve operational synergies among the regulated pipeline operations (both interstate and local) in terms of the corporate and information services that are provided by Southern Union to its operating affiliates (Tr. at 20-21). To the extent that fixed overhead costs can be allocated over a larger operation, local distribution customers in Massachusetts will benefit.

Conversely, the acquisition of Southern Union Panhandle will have no negative effect on the Company's ability to manage its local gas distribution activities (Exh. SU-1, at 9-10). Southern Union will operate Southern Union Panhandle as a subsidiary with designated personnel and resources, similar to its operation of its local gas distribution companies. For Massachusetts

customers, who have not experienced a base-rate change for over six years, there will be no change in rates or service quality, since both are regulated by the Department. Customer rates will not be subject to change until such time that the Department approves such a change, which means that, in approving these proposals, the Department retains the latitude to review their impact on rates in a future proceeding.

Although consummation of the transaction, in the absence of an equity issuance and other debt repayment initiatives, would have a negative effect on the capitalization ratios of the Company, the Company has met the public interest standard in this case because the totality of the proposal will have the effect of strengthening the financial position of the Company. Without the equity issuance, the investment community is unlikely to perceive that the Company is taking the steps necessary to recapitalize and restructure the balance sheet (*id.*). Therefore, the Company has requested authorization to undertake an equity issuance coincident with, or shortly after, the consummation of the transaction. Moreover, the record shows that financial analysts, ratings agencies, lenders and investment bankers have reacted favorably to the proposed acquisition and announced plan to recapitalize the balance sheet (*id.*). Therefore, taken as a whole, the proposed transaction and stock issuance will allow the Company to take a significant step toward a strengthened financial position. Accordingly, balancing all of the considerations involved in the transaction, customers will be at least as well served by the Department's approval of the proposed transactions as by its denial.

B. The Company Has Demonstrated That the Issuance Is Reasonably Necessary to Accomplish a Legitimate Utility Purpose

The record demonstrates that the primary objective of the Company's proposed issuance is to allow for the repayment of indebtedness for the purpose of strengthening the Company's consolidated balance sheet. To that end, the record shows that the Company's debt-to-equity ratio as of September 30, 2002, is approximately 65 percent debt to 35 percent equity (Exh. SU-4; Tr. at 74; SRR DTE 1-1). The also record shows that when the balance sheet for Southern Union Panhandle is consolidated with that of Southern Union following the transaction, the debt-to-equity ratio would change to 73 percent debt and 27 percent equity, without the equity issuance (Exh. SU-4; Tr. at 75). For this reason, the Company is requesting authorization to issue equity in conjunction with the proposed transaction, or shortly thereafter, which will result in a capitalization ratio of approximately 68 percent debt and 32 percent equity (SRR DTE 1-2). However, the record also shows that, in addition to the equity issuance, the Company will undertake a series of steps to further improve its capitalization ratios.

Specifically, the record shows that the Company anticipates raising additional cash from the sale of the LNG assets currently held by Panhandle Eastern (SRR-DTE-1-2). The financial projections that the Company is presenting to ratings agencies and financial analysts reflect the sale of Panhandle's LNG operations at an estimated price of \$550 million, which would include the assumption of \$284 million in debt by the purchaser (id.). As a result, the sale will have the effect of both reducing debt on the consolidated balance sheet and generating approximately \$266 million in cash, of which \$207 million will be available to the Company for the repayment of debt (the difference belonging to AIG) (id.).

As a result, the record shows that the effect of the anticipated sale of the LNG assets would reduce long-term debt by approximately \$491 million (\$207 million in cash and the

assumption of \$284 million in debt by the purchaser), in addition to the issuance of \$300 million in equity (SRR-DTE-2(b)). The resulting capitalization ratios show total debt and preferred securities of 62.36 percent and commonstockholders' equity of 37.64 percent, which yield a debt-to-equity ratio of 1.65, which is within the range for an investment-grade credit rating (Schedule SRR-DTE 1-2(b)). In combination with the Company's plan to further reduce debt by improving cash flow, the Company's debt-to-equity ratio will remain within acceptable ranges to retain an investment grade (SRR DTE 1-2; Tr. at 76).⁸

In addition to the repayment of long-term debt, the Company stated that it will use the proceeds from the stock issuance to redeem existing preferred securities and to fund utility operations (Exh. SU-1, at 15-16; Tr. at 32). Therefore, the proposed issuance is consistent with the Company's utility-service obligations. Accordingly, the issuance of stock to repay long-term debt, redeem existing preferred securities and to fund utility operations meets the first prong of the Department's two-part standard.

C. The Company Has Demonstrated That Its Net Utility Plant Will Exceed Its Total Capitalization Following the Stock Issuance

The Company has demonstrated (consistent with the requirements of the Department's net-plant test) that its net utility plant equals or exceeds its total capitalization and will continue to do so following the proposed issuance, pursuant to G.L. c. 164, § 16. See New England Power Company, D.T.E. 00-53, at 10; Boston Edison Company, D.T.E. 00-62, at 9-10. Specifically,

⁸ The record indicates that, even without the purchase of Panhandle Eastern, the Company would have sought the Department's approval to issue equity in the near future (Tr. at 41; 76-77). On a stand-alone basis following the stock issuance, the Company's cost of capital would be 9.837 percent as a result of the increased amount of equity and the repayment of debt with the equity-issuance proceeds (SRR DTE 1-4). With the investment and debt issuance, the Company's cost of capital is reduced to 8.097 percent (*id.*).

the record indicates that, following the issuance of preferred and/or common stock with an aggregate value of up to \$300 million, the Company will have net-utility plant in excess of total capitalization of approximately \$381,667,000 (Exh. SU-1, at 16-24; Exh. SU-4). In calculating the Department's net-plant test, the Company incorporated a number of adjustments, which are supported by Department precedent.

First, the Company removed from Property, Plant and Equipment, the net-utility plant associated with the Texas operations. In total, the Company removed \$301,007,000 from net-utility plant (including Construction Work In Progress), plus \$7,161,000 associated with the gas inventories. Because the Company received cash from the sale of the Texas property and the cash is not included as part of capitalization for the net-plant calculation, the Company did not adjust capitalization to reflect the sale of the Texas operations (id.). The change in capitalization associated with this sale is accounted for in the post-issuance capitalization adjustments (id.).

Second, the Company has removed from Property, Plant and Equipment, the net property, plant and equipment relating to unregulated business operations. Accordingly, the Company has reduced its net plant-in-service by \$14,649,000 (plant-in-service of approximately \$16,340,000, less accumulated depreciation of approximately \$1,691,000), to reflect the unregulated operations that are shown on a consolidated basis on the Company's balance sheet (id.). Consistent with this adjustment to net utility plant-in-service, the Company has reduced its total capitalization by approximately \$14,649,000 to reflect the removal of unregulated property, plant and equipment from the net-utility plant for the purpose of the "net-plant test" calculation (id.).

The unregulated property, plant and equipment removed from the net-utility plant-in-service is supported by a combination of debt and equity, but having been incorporated over time into the Company's overall operations, cannot be directly attributed to a particular source of capital (id.). Accordingly, the Company has reduced its total capitalization in the amount of \$14,649,000 by reducing outstanding debt and equity (both common and preferred) in the same ratio that those

categories of capital have to the Company's total capitalization (id.). This adjustment is consistent with the Department's treatment in previous cases presented by Southern Union and with the Department's precedent, which requires a utility to demonstrate that its net-utility plant-in-service will be equal to or exceed its total capitalization following the issuance of the security for which it is seeking authorization by the Department. See e.g., Southern Union Company, D.T.E. 02-27 (2002); Southern Union Company, D.T.E. 01-32, at 6, 10-11 (2001); Southern Union Company, D.T.E. 01-52, at 4-5 (2001).

Third, consistent with Department precedent, the Company adjusted the net-plant-test calculation to exclude the net goodwill totaling \$642,921,000 from the Company's overall capitalization (net goodwill excluding goodwill associated with the Texas operations). Id. Over the past several years, the Company has completed a number of acquisitions of regulated natural gas companies. The net goodwill of \$642,921,000 reflects the excess of the purchase prices of the acquired companies over the book value of the assets acquired (Exh. SU-1, at 16-24; Exh. SU-4). Thus, the Company has reduced its total capitalization by \$642,921,000 to reflect the removal of the net goodwill from the net-plant-test calculation (id.).

The net goodwill is supported by a combination of debt and equity, but having been incorporated over time into the Company's overall operations, cannot be directly attributed to a particular source of capital. Accordingly, the Company has reduced its total capitalization in the amount of \$642,921,000 by reducing outstanding debt and equity in the same ratio that those categories of capital have to the Company's total capitalization (id.).

Fourth, the Company has excluded Retained Earnings of approximately (\$6,495,000) from its total capitalization (id.; Exh. 23). Also, the Company has made pro-forma adjustments to its

consolidated balance sheet to remove Construction Work In Progress of \$12,409,000, and to include natural gas inventories held by the Company's regulated utility divisions (excluding Texas), which total approximately \$124,794,000 (Exh. SU-1, at 16-24; Exh. SU-4).

The Company added to "Common Stockholders' Equity" the acquisition of the equity interest in Southern Union Panhandle, or \$662,300,000 (id.). Following the closing of the Eastern Panhandle acquisition, the balance sheet of Southern Union Panhandle will be consolidated with Southern Union's and the net property, plant and equipment associated with the Panhandle assets will be reflected on Southern Union's balance sheet, as will the "minority interest" of \$150 million held by AIG Highstar (id.). Accordingly, the Company has increased "Common Stockholders' Equity" by \$662,300,000 and increased its net plant in service by \$1,747,100,000 to account for the addition of the Southern Union Panhandle facilities, plus \$61,000,000 for gas inventories (id.). The Company has also included Panhandle Eastern's long-term debt of \$1,167,000,000, which will be assumed by Southern Union Panhandle as part of the transaction (id.).

The Company has made certain adjustments to depict the capitalization of the Company following the closing of the Panhandle Eastern acquisition and the consolidation of Southern Union Panhandle Eastern's balance sheet with that of Southern Union. Specifically, the Company has reduced "Common Stockholders' Equity" to account for the \$420 million in cash invested in Southern Union Panhandle using the Texas proceeds (id.). This adjustment is made because the \$420 million cash realized from the sale of the Texas operations and invested in Southern Union Panhandle represents "Common Stockholders' Equity" for Southern Union Panhandle (on a stand-alone basis), but does not for Southern Union on a consolidated basis (id.). Therefore, the \$420

million cash investment must be removed from Common Stockholders' Equity on Southern Union's consolidated balance sheet (id.).

Next, the Company removed from "Common Stockholders' Equity" the amount of \$92,300,000, which represents funding for the investment that will be accomplished using short-term debt facilities, and therefore does not constitute Common Stockholders Equity (id.). As a result of these two adjustments to Common Stockholders' Equity, the balance remaining in the equity component of the capital structure is the minority interest held by AIG Highstar of \$150,000,000, or \$662,300,000, less \$512,300,000 invested by Southern Union (id.).

Lastly, the Company adjusted for the issuance of up to \$300 million in common equity. Since the proceeds will be used to reduce long-term debt, the Company increased Common Stockholders' Equity and reduced Long-Term Debt by \$300 million (id.). Thus, as demonstrated by the record, the Company's net-plant in service exceeds capitalization by approximately \$381,667,000, prior to the issuance, which is sufficient to support an equity issuance with an aggregate value of up to \$300 million (id.).

VI. CONCLUSION

The record in this proceeding shows: (1) that the investment and related guarantee of up to approximately \$662.3 million for the purpose of acquiring Southern Union Panhandle is in the public interest as required by G.L. c. 164, § 17A; and (2) that the issuance of preferred and/or common stock in an aggregate value of \$300 million is reasonably necessary and is in the public interest as required by G.L. c. 164, § 14; and (3) that the issuance of preferred and/or common stock up to an aggregate value of \$300 million meets the Department's net-plant test, pursuant to G.L. c. 164, § 16. Therefore, for the reasons stated above, the Department should:

VOTE: That the investment and related guarantee of up to \$662.3 million in Southern Union Panhandle Corp. is in the public interest as required by G.L. c. 164, § 17A.

VOTE: That the issuance of common and/or preferred stock up to an aggregate value of \$300 million is reasonably necessary and is in the public interest as required by G.L. c. 164, § 14.

VOTE: That the issuance of common and/or preferred stock up to an aggregate value of \$300 million meets the Department's net-plant test, pursuant to G.L. c. 164, § 16.

ORDER: That the investment and related guarantee by Southern Union of up to \$662.3 million in Southern Union Panhandle Corp. is approved and authorized;

ORDER: That the issuance of up to \$300 million of common and/or preferred stock is approved and authorized; and

ORDER: That such other and further orders and approvals are granted as may be necessary or appropriate.

Respectfully submitted,

SOUTHERN UNION COMPANY

By its attorneys,

Cheryl M. Kimball, Esq.
Andrew O. Kaplan, Esq.
Keegan, Werlin & Pabian, LLP
21 Custom House Street
Boston, MA 02110
(617) 951-1400

Dated: February 5, 2003

Southern Union Company
D.T.E. 03-3

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BRIEF OF SOUTHERN UNION COMPANY

Submitted by:

Cheryl M. Kimball, Esq.
Andrew O. Kaplan, Esq.
Keegan, Werlin & Pabian, LLP
21 Custom House Street
Boston, MA 02110
(617) 951-1400

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